Testimony of the Honorable Michael M. Reyna
Chairman and Chief Executive Officer
Farm Credit Administration
Before the
Subcommittee on Agriculture, Rural Development,
Food and Drug Administration, and Related Agencies
Committee on Appropriations, U.S. House of Representatives

Mr. Chairman, Members of the Subcommittee, I am Michael Reyna, Chairman and Chief Executive Officer (CEO) of the Farm Credit Administration (FCA or agency). This is my third report to you as the Chairman of the FCA Board. As you know, the FCA Board is a three-member board. Ann Jorgensen, who also serves as the Chair of the Farm Credit System Insurance Corporation (FCSIC), joins me on the Board. The third position on the FCA Board is currently vacant.

I will highlight the FCA's accomplishments during the past year, report to you briefly on the condition of the Farm Credit System (FCS or System), and present our fiscal year (FY) 2003 budget request.

ROLE AND RESPONSIBILITY OF THE FARM CREDIT ADMINISTRATION

The role and responsibility of the FCA is to ensure a financially safe and sound FCS so that agriculture and rural America will have continuous access to a dependable and affordable source of credit and related services.

The agency accomplishes its mission in two important ways. First, the agency conducts on-site financial safety and soundness examinations of each System institution. Specifically, these examinations focus on a number of areas including an institution's capital, assets, management, earnings, liquidity and sensitivity to risk. These examinations also focus on an institution's efforts to serve all eligible borrowers having a basis for credit, including young, beginning and small farmers and ranchers.

Secondly, the FCA Board reviews and approves corporate charter changes and researches, develops and adopts rules, regulations and other guidelines that govern how System institutions conduct their business and interact with their customers. If, in the conduct of its business, a System institution violates a law or regulation, or does not meet safety and soundness standards, we can use our enforcement authorities to ensure the problem is corrected promptly.

The agency strives to maintain a regulatory environment that enables System institutions to remain financially strong and competitive so they can meet the changing demands of rural America for credit and other services. In doing so, our primary focus is to ensure the long-term safety and soundness of the FCS and develop rules and polices that respect market forces.

FISCAL YEAR 2003 BUDGET REQUEST

Before I present the budget request, I respectfully bring to the Subcommittee's attention that the FCA's administrative expenses are paid for by the institutions that we examine. The FCA does not receive a Federal appropriation, but, instead, is funded through annual assessments of FCS institutions.

Earlier this fiscal year the agency submitted a proposed budget of $38,033,000 for FY 2003. The proposed budget request is slightly below our FY 2002 total budget. The agency's proposed budget contemplates an assessment on System institutions for FY 2003 that remains unchanged from $36,700,000 in FY 2002.

Since the preparation and submission of our proposed FY 2003 budget, several new factors have been brought to my attention by agency staff that will likely necessitate changes to the agency's budget as proposed. These factors are as follows:

First, the Office of Management and Budget (OMB) has proposed accounting changes for federal employee retirement benefits that would result in a substantial increase in FCA's budget and related assessment. Under the OMB proposal, FCA and other federal agencies would be required to pay the full government share of the accruing cost of retirement for employees under the Civil Service Retirement System (CSRS) and, for all employees, the cost of post-retirement health benefits. Staff estimates that the first year cost in FY 2003 would be $1.8 million.

Secondly, the agency is required by statute to provide its employees with compensation that is comparable with that of other federal financial regulatory agencies. Based on preliminary work done late last year to adjust our locality pay rates, the agency uncovered initial indications that our underlying compensation package was lagging that of other federal financial regulators. The agency is in the process of engaging the services of an outside expert to determine the magnitude of this compensation gap. While the results of this study will be available by mid-summer, we do not have concrete numbers to share with the Subcommittee at this time. Based on a preliminary review, it is possible that our salary structure could be lagging other federal financial regulators by as much as 12 percent, which could mean an additional $1 million.

Finally, FCA, like other federal agencies, has an aging workforce and, as a result, is facing the potential loss of many seasoned financial examiners and other employees through retirements. The agency is currently studying our workforce to determine the impact such retirements would have on our ability to continue to ensure the financial safety and soundness of System institutions.

For example, focusing on only the most critical positions – financial examiners – the agency could lose up to 26 examiners between now and the end of FY 2005. Specifically, we could lose 12 examiners in 2002; 6 examiners in 2003; 5 examiners in 2004 and 3 examiners in 2005. If all 26 retire, this alone could cost as much as $1.45 million. While not every examiner eligible to retire will, in fact, retire, it is clear that if the agency even loses 50 percent of those eligible, these departures will affect our ability to effectively monitor and control System risks. If just half of the potential retirements are replaced with 13 new hires it would cost up to $724,000 per year.

There are a number of reasons an employee may leave his or her job. Since the beginning of FY 2001, this agency has experienced a total of 16 departures by examiners. Seven departures were due to retirement, while nine employees left to pursue jobs at other federal agencies, jobs with System institutions or elsewhere, or to simply stay at home.

The trend in the number of departures, however, is only part of the picture. A critical issue is the valuable experience that the agency loses when a seasoned employee leaves. This is particularly important relative to the financial examiners the agency employs. This is because, on average, it takes between three and four years to train and commission a new examiner. While the agency hires new examiners on an ongoing basis, it now appears we may need to accelerate this process to address the impending "retirement bubble" the agency — like other federal agencies — is now facing.

As previously mentioned, the agency is currently studying this issue internally. We may need to contract with outside experts to assist us in determining our specific replacement needs given ongoing structural changes within the System itself. This is because while the number of System institutions continues to decline through mergers and restructurings, the resulting institutions are larger and tend to be involved in more complex and sophisticated activities and transactions. Hence, the agency needs to understand more completely, not only the number of examiners, but also the type of examiners we need to employ so as to effectively carry out our primary responsibility.

Information of this type may not be able to be developed until mid-summer. While we continue to fill vacancies as they occur, preliminary indications are that the agency may need to hire up to an additional 13 examiners to address the "retirement bubble" issue alone. The cost to hire and train an additional 13 examiners would be in the range of $724,000 a year.

The combined impact on our proposed budget resulting from these factors could be up to $3.5 million. I am not proposing to adjust our budget at this time; however, I would respectfully request that the Subcommittee consider raising the "cap" (limitation on administrative expenses) on our agency budget and assessment by $3.5 million to accommodate later changes if the studies the agency currently has underway indicate changes are necessary and appropriate. It is possible, because of funds in the agency reserve, that an increase in the assessment may not be necessary. Once I get the results of all the studies, as CEO I will present the information to the FCA Board to determine if a budget increase is necessary.

The agency has worked hard to hold down the assessment to the System for our operations, and I believe we have achieved that objective over the last several years. I think it should be clear to all who review our budget that we have been very good stewards of the resources entrusted to us to accomplish our responsibilities.

In FY 2001, System borrowers paid 3.4 basis points or about 3.4 cents for every $100 borrowed. This is the lowest assessment ever, and continues a trend to keep costs to the borrower at the absolute minimal amount. The lower cost is due primarily to on-going FCA cost efficiencies and to increases in the System's total assets.

I would specifically note that in an August 2001 report issued to Senator Richard Lugar, the General Accounting Office stated that FCA's administrative expenses "stayed within the congressionally imposed spending limits for each year during 1997 through 2000." The report went on to point out that, "Overall the agency experienced a decline in administrative spending of around $2 million, or 5.8 percent. As a point of reference, during this same period, the price index for federal government expenditures increased 8.6 percent."

My desire is to continue to be a good steward of the agency and its resources and our budget, which is why I have brought these issues to the Subcommittee's attention. And with the Subcommittee's assistance, I believe we can continue to maintain an appropriate mix of positions and skills necessary to implement our strategic plan and effectively accomplish our mission. The proposed budget that we formally submitted to the Subcommittee provides details on the various expense categories and other highlights.

We are proud of our accomplishments as the safety and soundness regulator of the FCS. I assure you that the agency will continue its commitment to effectiveness and cost efficiency. We will regularly review how additional progress can be made in meeting these objectives. I am personally committed to a program of continuous improvement.

FISCAL YEAR 2001 ACCOMPLISHMENTS

I am proud of our many accomplishments during the past year. 2001 was another busy year for the agency as it continued its efforts to achieve its strategic plan goals through (1) effective risk identification and corrective action, and (2) sensible regulation and public policy.

The agency has worked hard to maintain the System's safety and soundness at a time when the agricultural economy is experiencing stress. At the same time, the agency is continually exploring options to reduce regulatory burden on the FCS and ensure System institutions provide agriculture and rural America continuous access to credit and related services.

Examination Programs

One of the agency's highest priorities is the development and implementation of efficient and effective examination programs that meet the high standards and expectations of the Congress, investors in System debt obligations, the farmers, ranchers, and cooperatives that own System banks and associations, and the public at large. We conduct examinations according to risk-based examination principles, which means we set the scope and frequency of each examination based on the level of risk in the institution. We continuously identify, evaluate, and proactively address these risks. We also use an examination cycle of up to 18 months for certain institutions, where appropriate, as permitted by the Farm Credit System Reform Act of 1996.

The agency continually enhances its risk identification capabilities. Each institution is reviewed quarterly to identify changes in its risk characteristics, and the Financial Institution Rating System (FIRS) rating is adjusted as needed. In addition to the FIRS reviews, we use a semiannual financial forecasting model to identify and evaluate prospective risk in institutions over the upcoming 12 to 24 months under "most likely" and "worst case" scenarios. By evaluating each institution's financial condition and performance under various scenarios, we can identify institutions with emerging risk and the potential for adverse performance. This evaluation enhances our ability to carry out our risk-based supervision program. We continue to enhance our modeling capabilities so that we can identify, in a timely manner, economic developments that may affect the financial condition of FCS institutions.

On a national level, the agency also actively monitors risks that may affect groups of System institutions or even the entire System. These systemic risks cover the agricultural, financial, and economic environment within which the System institutions operate. Our job is not to forecast specific events, but to understand the environment well enough so that we can take steps in advance to help System institutions should adverse trends develop.

FIRS provides a general framework for collecting and evaluating all significant financial, asset quality, and management factors to assign a composite rating to each institution on a scale of 1 to 5, with 1 being the highest rating. Throughout FY 2001, FIRS ratings as a whole reflected the stable to improving financial conditions of FCS institutions, and the overall trend in FIRS ratings continued to be overwhelmingly positive.

I am especially pleased to note that more FCS institutions are rated "1" than are rated "2" or "3." In fact, there was only one 3-rated institution, which had $19 million in total assets at September 30, 2001. That institution merged with another association on November 1, 2001. Also good news is the fact that for the last three years, there has been a steady decline in the number of required corrective actions identified during our examination process. Even better news is that there were no System institutions under an enforcement action.

During FY 2001, the Small Business Administration (SBA) and the United States Department of Agriculture (USDA) also used FCA's examination expertise. SBA contracted with FCA to conduct examinations of financial companies licensed by SBA to make guaranteed loans to small businesses. USDA contracted with FCA to conduct examinations of financial companies licensed by USDA to make guaranteed loans under USDA's Business and Industry Guaranteed Loan program. I can assure you that the safety and soundness of the System remains our primary objective. However, I also believe the continuing use of FCA examination resources by other agencies is a positive reflection on the expertise of FCA examiners and serves to broaden their examination skills while increasing job satisfaction and employee retention. It also helps us to defray some of the costs of our operations while providing valuable assistance and service to other federal agencies.

Strategic Planning and Performance Plans

During FY 2001, FCA continued to focus on improving our methods for measuring the agency's performance under the strategic plan. We also continued our efforts to comply with the Government Performance and Results Act of 1993 by integrating the budgeting process into the agency's planning and performance management process. By linking performance goals with resource needs, the agency will be in a better position to use the strategic plan to align the organization and budget structures with our mission and objectives. This provides us with a tool to use in setting priorities and allocating resources consistent with these priorities, which will enable us to deal effectively with rapid changes in agriculture and the System during both strong and weak economic conditions. We also use performance measures and goals to assess our ultimate effectiveness in ensuring the safe and sound operation of the FCS.

Regulatory and Policy Initiatives

Congress has given the FCA Board statutory authority to establish policy and prescribe regulations necessary to ensure that FCS institutions comply with the law and operate in a safe and sound manner. We strive to adopt sound and constructive policies and regulations, using a proactive and preventive approach that reflects the changing needs of agriculture. Our objective is to promulgate regulations that achieve safety and soundness goals while minimizing regulatory burden on System institutions.

During FY 2001, we were very busy on the regulatory front. Our agency regulatory agenda was dominated by the debate and discussion surrounding whether territorial boundaries for System associations should be eliminated – the National Charter proposal. This proposal generated more comment than any proposed rule before the agency in the past decade. In fact, we received more than 1,500 comments on this rule. In the end, the FCA Board chose to withdraw the proposal, but I believe the process of considering the rule was a positive experience. Healthy public debate on important and critical public policy issues is an essential component to good decision making on matters of public policy.

In addition to the National Charter proposal, we tackled other important regulatory proposals that would:

- Allow service corporations to sell stock to non-System investors;
- Remove regulatory barriers to e-commerce so as to facilitate the safe and sound use of new technologies by System institutions and their customers;
- Enable System institutions to terminate their FCS charter and become a financial institution under another federal or state chartering authority;
- Establish risk-based capital regulations for Farmer Mac; and
- Allow System institutions to purchase or sell 100 percent loan participations.

Corporate Activities

Farm Credit System corporate mergers and restructuring proposals during FY 2001 exceeded the fast pace established in FY 2000. During the past year, we processed and approved a total of 69 corporate restructuring proposals from System institutions. This was 10 more than reviewed and approved during FY 2000.

Again in FY 2001, many FCS associations have merged or adopted new corporate structures that include wholly owned operating subsidiaries. These restructurings are expected to lower risk through diversification, reduce operating expenses, and enable associations to use their capital more efficiently while offering their customers a broader array of services on a one-stop basis. We believe that this evolution in corporate structure is essential for the System and that it will enable FCS associations to better serve the needs of their borrowers.

CONDITION OF THE FARM CREDIT SYSTEM

I am pleased to report that the System's overall condition and performance was solid and steady during FY 2001. Capital levels have continued to increase, mostly through retained earnings. Asset quality has remained high, even during moderate loan growth, and year over year earnings were up once again. By in large, the System has knowledgeable and experienced managers at all levels.

The FCS is a financially strong and reliable source of affordable credit to agriculture and rural America. The quality of loan assets, risk-bearing capacity, stable earnings, and capital levels collectively reflect a healthy Farm Credit System.

Loan volume continued to grow during FY 2001 while loan quality remained high. Gross loans increased almost 10 percent to $80.1 billion. The level of nonperforming loans, including nonaccrual loans,[1] consistently remains low. Delinquencies also remained minimal.

Since 1993, the System has steadily earned $1 billion or more each year. This has resulted in a large capital cushion that will enable the System to absorb losses and remain a viable lender to agriculture during downturns in the agricultural economy.

Total capital as a percentage of total assets has increased from 13.8 percent as of September 30, 1995, to 15.8 percent as of September 30, 2001. All institutions met their regulatory capital requirements, and most greatly exceeded them. Permanent capital ratios at System banks and associations ranged from a low of 10.4 percent to a high of 30.6 percent compared with the 7.0 percent minimum regulatory capital requirement.

While the overall condition of the System continued to improve during FY 2001 and remained strong, I must also offer a cautionary note. Commodity prices continue to remain at or near all time lows, while interest rates were near 40-year lows and could increase in the coming months. Government payments to agricultural producers continue to account for around 40 percent of net farm income. Debt repayment problems, and a resulting upsurge in credit quality problems at System institutions, could impact those producers who benefit from these payments, if low commodity prices continue and are combined with cost increases and a significant reduction in government program payments. In addition, the declining general economy may present similar problems for the many farmers with off-farm income.

[1] Nonperforming loans consist of nonaccrual loans, accruing restructured loans, and accruing loans 90 days or more past due.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION

The FCA has oversight and examination responsibility for the Federal Agricultural Mortgage Corporation, which is commonly known as Farmer Mac. Congress established Farmer Mac in 1988 to operate a secondary market for agricultural mortgage and rural home loans. In this capacity, Farmer Mac creates and guarantees securities that are backed by mortgages on farms and rural homes. The agency monitors Farmer Mac's operations and financial condition and provides periodic and timely reports to Congress.

On February 21, 2001, we adopted a final risk-based capital regulation for Farmer Mac that became effective May 23, 2001. Because of a one-year period to allow for the rule's orderly implementation, Farmer Mac will not be required to comply with all aspects of the rule until May 23, 2002. The risk-based capital regulation is designed to ensure that Farmer Mac has sufficient capital to meet its mission, especially during times of economic stress. The final rule establishes a risk-based capital stress test that will determine the minimum level of risk-based regulatory capital necessary for Farmer Mac to maintain positive capital during a 10-year period if stressful credit and interest rate conditions occur. The final rule requires Farmer Mac to run the risk-based capital stress test at least quarterly to determine the adequacy of its capital and to report the results to the FCA. The stress test is based on a statistical model used to project Farmer Mac's capital sufficiency over the 10-year stress period.

The FCA continues to monitor Farmer Mac's debt issuance and non-mortgage investment strategy. The agency also examines Farmer Mac's strategic and operational business planning. In 2001, Farmer Mac had $ 16.3 million in net earnings, compared with $10.4 million in 2000 and $6.9 million in 1999. Farmer Mac's capital remains above the minimum prescribed by the

Act and its total program activity continued to increase, reaching $4.19 billion at December 31, 2001.

In conclusion, the agency is proud of our efforts and accomplishments in ensuring the safety and soundness of the Farm Credit System. We will remain ever vigilant in our efforts to ensure the System remains financially strong and mission focused on agriculture and rural America for generations to come. Mr. Chairman, on behalf of Board Member Ann Jorgensen, and myself, I thank you for the opportunity to share this information with you.